In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 1348

PACIFIC NATIONAL INSURANCE COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The memorandum opinion and order of the district court (Pet. App. 19-35) is reported at 270 F. Supp. 165. The opinion of the court of appeals (Pet. App. 2-16) is not yet officially reported.

JURISDICTION

The judgment of the court of appeals was entered on February 6, 1970. A petition for rehearing was filed on February 13, 1970, and denied on March 3,

1970 (Pet. App. 1). The petition for a writ of certiorari was filed on March 24, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether, in the circumstances of this case, petitioner was a "person" required to account for and pay over withholding taxes under Section 6672 of the Internal Revenue Code, and whether its failure to do so was "willful" within the meaning of that provision.

2. Whether, on the facts, the Internal Revenue Service properly applied funds collected to tax liabilities other than the liability for withholding taxes here in dispute.

STATUTES INVOLVED

The pertinent statutory provisions applicable to the taxable periods here in issue are set forth in Appendix A, *infra*, pp. 10-11. Section 3505 of the Internal Revenue Code, which was added by the Federal Tax Lien Act of 1966, is set forth in Appendix B, *infra*, pp. 12-13.

STATEMENT

I

Petitioner, a surety, wrote payment and performance bonds on six government contracts awarded to Central States Construction and Equipment Company ("Central"). When Central exhausted its operating funds in April, 1955, petitioner provided the

financing necessary to meet net payrolls and thereby permit Central to continue work under its contracts, but refused Central's specific request to provide funds for the payment of May, 1955, withholding taxes. (Pet. App. 2-3, 5.)

In June, 1955, petitioner arranged and guaranteed a bank loan for Central in the estimated amount of progress payments due Central under its government contracts. The loan proceeds were deposited in special accounts over which petitioner had exclusive control. Although progress payments were assigned to the lending bank, petitioner had the power to determine whether the payments would be deposited in the special accounts or applied to reduce the bank loan. (Pet. App. 5-6.)

From May, 1955, to September 8, 1955, when Central defaulted on the government contracts, petitioner was fully responsible for payment of wages to Central's employees. Central prepared payrolls showing gross wages, withholding and social security deductions, and net wages for each employee, and prepared checks in the amount of each employee's net wages. Petitioner approved the checks, secured the employees' endorsements thereon, deposited the net amount of the total payroll to Central's account, cashed the endorsed checks and paid Central's employees in cash. (Pet. App. 5, 6.)

With respect to non-payroll expenses, Central prepared lists of such expenses and forwarded them to petitioner together with checks for each creditor listed. Petitioner determined which creditors should be paid, mailed the checks to the selected creditors, and

transferred sufficient funds from the special accounts to Central's account to cover the total. (Pet. App. 7.)

Central understood that as part of the June financing arrangement with the bank, petitioner would approve payments of all taxes required to be withheld from its employees' wages. Central would not have placed all of its potential income under petitioner's exclusive control had it known that petitioner would not release funds to cover withholding taxes. However, petitioner refused Central's subsequent requests to provide funds for payment of withheld taxes. As a result, although Central's quarterly tax returns showed withholding tax liability for the second and third quarters of 1955, no part of the taxes withheld were remitted to the government as required by Sections 3102 and 3403 of the Internal Revenue Code. (Pet. App. 3, 6.)

The district court held that, pursuant to Section 6672 of the Code, petitioner was a "person" required to collect and pay over withholding taxes, and that petitioner had "willfully" failed to do so. It accordingly sustained the Commissioner's determination that petitioner was liable under that section for a penalty of $52,881.30, the amount of Central's unpaid withholding tax liability for the second and third quarters of 1955. (Pet. App. 35.) On appeal, the Ninth Circuit affirmed (Pet. App. 3).

II

Prior to May 5, 1958, the government collected $40,411.22 from Central, which it applied, in accord-

ance with established policy, to Central's withholding tax liabilities for periods prior to the second and third quarters of 1955, and to Central's non-withholding tax liabilities. At no time prior to this allocation did Central or petitioner request that the funds collected be applied to any particular tax liability. (Pet. App. 16, 44.)

On these facts, both courts below held that there was no merit to petitioner's claim that the funds should be applied to Central's withholding tax liability for the second and third quarters of 1955. Petitioner thus was not entitled to reduce its liability for the Section 6672 penalty by the amount of the funds collected.

ARGUMENT

The decision below is correct. There is no conflict or any other reason for further review by this Court. Moreover, the principal question raised in the petition has been resolved for the future by the addition to the Code of Section 3505, which specifically requires the result reached by the courts below.

1. Section 6672 of the Code imposes a penalty equal to the full amount of the tax due on "[a]ny person" required to collect and pay over tax who "willfully" fails to do so. In holding that petitioner was such a "person" in the circumstances of this case, the court below followed well-reasoned authority to the effect that Congress intended Section 6672 to apply not merely to a corporate employer initially responsible for withholding taxes, but to all persons respon-

sible for failure to pay over withheld taxes,[1] and particularly those that have the final word as to what liabilities of a corporation should be discharged. See *United States* v. *Graham*, 309 F.2d 210, 212 (C.A. 9); *Wilson* v. *United States*, 250 F.2d 312, 316 (C.A. 9); *White* v. *United States*, 372 F.2d 513, 517 (Ct. Cl.); *Regan & Co.* v. *United States*, 290 F. Supp. 470 (E.D. N.Y.). Here, petitioner not only made the final determination as to which creditors of Central would be paid, but exercised exclusive control over the disposition of all funds available to Central.

Likewise in keeping with prior authority is the court of appeals' conclusion that petitioner's failure to pay over the withheld taxes was "willful." Petitioner knew that the taxes were owing; it had exclusive control over Central's fiscal affairs; and it caused Central's funds to be paid to creditors other than the United States. Petitioner's failure to discharge the withholding tax liability thus was "willful" because it constituted a voluntary, conscious and intentional act.[2] See *Bloom* v. *United States*, 272 F.2d 215 (C.A.

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[1] Section 6671(b) provides that, for purposes of Section 6672, "[t]he term 'person' * * * includes an officer or employee of a corporation" and does not, in terms, refer to others that may be responsible for a failure to pay over withheld taxes. However, as the Ninth Circuit held (Pet. App. 8-9), the use of the word "includes" in the statute makes it clear that corporate officers and employees are only examples of persons that may be liable for the Section 6672 penalty.

[2] Petitioner's contention (Pet. 31-33) that Section 6672, as construed by the Ninth Circuit, is unconstitutional because it would impose a penalty on one taxpayer for failure to pay the taxes of another is without merit. When an employer withholds social security and income taxes from wages paid

9), certiorari denied, 363 U.S. 803; *Dillard* v. *Patterson*, 326 F.2d 302 (C.A. 5); *Flan* v. *United States*, 326 F.2d 356 (C.A. 7).

2. There is no conflict between the decision below and *United States* v. *Hill*, 368 F.2d 617 (C.A. 5), as petitioner contends (Pet. 21-27). In *Hill*, unlike this case, it was uncontroverted (368 F.2d at 623) that the employer retained control over corporate funds and that there were sufficient unencumbered funds to permit discharge of the tax liability. Moreover, as the court below observed (Pet. App. 14-15), the Fifth Circuit in *Hill* did not base its decision on the language of Section 6672, but relied on cases involving 1939 Code provisions imposing liability only upon sureties under the terms of their payment bonds or upon employers. *Hill* did not hold that Section 6672 could not, under certain circumstances, apply to a person advancing payroll funds to an employer.

Nor is there a conflict with *Frazier* v. *United States*, 304 F.2d 528 (C.A. 5) (see Pet. 27-31). In that case, the Fifth Circuit stated that liability under Section 6672 might be avoided upon a showing of reasonable cause for failure to pay over withheld taxes. However, the court went on to hold that such a failure was without reasonable cause, and therefore "willful," where the person paying the employees' wages knew of the obligation to pay withholding

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to employees, he is collecting at the source taxes imposed on the employees. Section 6672 serves only to impose liability on the person responsible for the failure to account for or pay over to the United States the funds so collected. *Cash* v. *Campbell*, 346 F.2d 670, 673 (C.A. 5).

taxes thereon and instead made payments to creditors other than the United States. Thus, it seems clear that the Fifth Circuit would have concluded, as did the Ninth Circuit below, that petitioner's failure to pay over withheld taxes was "willful" within the meaning of Section 6672.

At all events, Section 3505 of the Code, which was added by the Federal Tax Lien Act of 1966, resolves the question presented for the future[3] by expressly imposing liability on the lender or surety in the circumstances of a case like this one. Accordingly, even if there were a conflict with the decision below, this case would not warrant review by this Court.

3. Petitioner also contends (Pet. 33-36) that the Internal Revenue Service erroneously applied funds it collected from Central to Central's tax liabilities other than its liability for withholding taxes for the second and third quarters of 1955. This argument is incorrect. Where, as in this case, there is no request for a particular application of funds, the Service may apply the funds in accordance with established procedures. It was stipulated by the parties that these procedures were followed with regard to the funds here in dispute.

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[3] Section 3505 applies generally after November 2, 1966, the date of enactment of the 1966 Act. Sec. 114(a), P.L. 89-719, 80 Stat. 1146.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MAY 1970.

APPENDIX A

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 3102. DEDUCTION OF TAX FROM WAGES.

(a) *Requirement.*—The tax imposed by section 3101 shall be collected by the employer of the taxpayer, by deducting the amount of the tax from the wages as and when paid. * * *

(b) *Indemnification of Employer.*—Every employer required so to deduct the tax shall be liable for the payment of such tax, and shall be indemnified against the claims and demands of any person for the amount of any such payment made by such employer.

* * * *

SEC. 3403. LIABILITY FOR TAX.

The employer shall be liable for the payment of the tax required to be deducted and withheld under this chapter, and shall not be liable to any person for the amount of any such payment.

SEC. 6671. RULES FOR APPLICATION OF ASSESSABLE PENALTIES.

* * * *

(b) *Person Defined.*—The term "person", as used in this subchapter, includes an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs.

SEC. 6672. FAILURE TO COLLECT AND PAY OVER TAX, OR ATTEMPT TO EVADE OR DEFEAT TAX.

Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. No penalty shall be imposed under section 6653 for any offense to which this section is applicable.

APPENDIX B

Internal Revenue Code of 1954, as amended (26 U.S.C. (Supp. IV)):

SEC. 3505 [as added by Sec. 105(a), Federal Tax Lien Act of 1966, P.L. 89-719, 80 Stat. 1138]. LIABILITY OF THIRD PARTIES PAYING OR PROVIDING FOR WAGES.

(a) *Direct payment by Third Parties.*—For purposes of sections 3102, 3202, 3402, and 3403, if a lender, surety, or other person, who is not an employer under such sections with respect to an employee or group of employees, pays wages directly to such an employee or group of employees, employed by one or more employers, or to an agent on behalf of such employee or employees, such lender, surety, or other person shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) required to be deducted and withheld from such wages by such employer.

(b) *Personal Liability Where Funds Are Supplied.*—If a lender, surety, or other person supplies funds to or for the account of an employer for the specific purpose of paying wages of the employees of such employer, with actual notice or knowledge (within the meaning of section 6323 (i)(1)) that such employer does not intend to or will not be able to make timely payment or deposit of the amounts of tax required by this subtitle to be deducted and withheld by such employer from such wages, such lender, surety, or other person shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) which are not paid over to the United States by such employer

with respect to such wages. However, the liability of such lender, surety, or other person shall be limited to an amount equal to 25 percent of the amount so supplied to or for the account of such employer for such purpose.

(c) *Effect of Payment.*—Any amounts paid to the United States pursuant to this section shall be credited against the liability of the employer.

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